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Canada's New Government Signs Protocol to the Canada-U.S Tax Treaty for the Benefit of Canadians

The Honourable Jim Flaherty, Minister of Finance, today signed an important tax agreement with Henry M. Paulson, Jr., U.S. Secretary of the Treasury, concluding nearly 10 years of negotiations.

"We are modernizing a long-standing treaty for the betterment of individuals and businesses on both sides of the border, including manufacturers," said Minister Flaherty. "Today we have signed an agreement that will stimulate further trade and investment and make our tax systems more efficient."

The fifth update of the Canada-U.S. Tax Treaty:

- eliminates withholding taxes on cross-border interest payments;
- extends treaty benefits to limited liability companies;
- allows taxpayers to require that certain key double tax issues, such as transfer pricing, be settled through arbitration;
- ensures that there is no double taxation on emigrants' gains;
- gives mutual tax recognition of pension contributions; and
- clarifies how stock options are taxed.

The agreement signed today is a set of changes to the existing Canada-United States Income Tax Convention, one of over 85 bilateral tax treaties that Canada has with other countries. First signed in 1980, the Convention has been updated four times in the past through agreements known as Protocols.

Minister Flaherty and Secretary Paulson signed the Protocol at Willson House, a 100-year-old heritage property overlooking Quebec's Meech Lake. After the signing ceremony the Secretary and the Minister spoke briefly to reporters, noting that the Protocol reflects the strength and depth of the Canada-United States partnership.

"With the signing of this document, we have concluded nearly a decade of negotiations and strengthened the bonds of economic co-operation between our two countries," said Minister Flaherty. "In this highly competitive global economy, we need to continually explore ways to grow, expand and compete. Further improving and refining our relationship with our friends and neighbours to the south is essential."

"After nearly 10 years of negotiations, we are delighted that the government has signed an updated Canada-U.S. Tax Treaty," said Perrin Beatty, President and Chief Executive Officer of the Canadian Chamber of Commerce. "The economic benefits to Canada stemming from the elimination of the withholding tax on interest paid are tremendous and will result in a substantial increase in capital and foreign direct investments in Canada."

"This is good for business, consumers and the Canadian economy," said Nancy Hughes Anthony, President and Chief Executive Officer of the Canadian Bankers Association. "The elimination of this tax will result in increased investment, reduced cost of capital, and more efficient North American capital markets. It is the right move."

"Getting the Canada-U.S. Tax Treaty signed is certainly good news for Canada, and especially for venture capital markets, the seedbed of innovation," said Finn Poschmann, Director of Research with the C.D. Howe Institute. "And our research suggests that the bilateral elimination of withholding taxes will substantially improve the efficiency of capital markets, attract foreign direct investment to the country, and help Canadians penetrate the North American market on a more competitive basis."

This agreement must now be ratified in the House of Commons in Canada and in the United States Senate. Minister Flaherty is encouraging legislators of all political stripes to lend their support and pass the Protocol quickly.

Two diplomatic notes setting out more technical aspects of the agreement were also exchanged today. The Protocol and the diplomatic notes are attached.

Also attached is a backgrounder that provides additional information on the Canada-United States Income Tax Convention and today's agreement. The full text of the Protocol can be viewed on the Department of Finance website at www.fin.gc.ca.

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BACKGROUNDER

THE FIFTH PROTOCOL TO THE CANADA-UNITED STATES INCOME TAX CONVENTION

Key Points

- Tax treaties prevent double taxation, aid tax enforcement and enhance co-operation.
- Within Canada's network of over 85 tax treaties, the *Canada-United States Income Tax Convention* is especially important.
- The Convention was signed in 1980. This is the fifth set of changes ("protocols") since then.
- The Fifth Protocol delivers significant benefits to Canadian individuals and businesses, by:
    - eliminating source-country "withholding" tax on cross-border interest payments;
    - allowing taxpayers to require that otherwise insoluble double tax issues be settled through arbitration
    - ensuring that there is no double taxation of emigrants' gains;
    - extending treaty benefits to "limited liability companies";
    - giving mutual tax recognition of pension contributions;
    - clarifying how stock options are taxed; and
    - implementing many technical improvements and updates.
- To become part of Canada's law, the Fifth Protocol has to be enacted by Parliament. The Government plans to introduce the required legislation at an early opportunity.

Important Note: This Backgrounder is a general, plain-language guide to rules, documents and practices that are inherently complex. While every effort has been made to ensure accuracy, this guide is neither a complete technical description nor an official interpretation of the subjects it discusses. The examples provided are simplified cases that are not intended to depict actual persons or transactions.

Tax treaties

Whenever a resident of one country earns income in another country – whether by carrying on business, making an investment or being employed there – there is potential for double taxation. This is because both the person's country of residence and the country where the income is earned can legitimately assert rights to tax the same income.

To prevent this double taxation, countries sign bilateral tax treaties (also known as tax conventions or double taxation agreements (DTAs)). These agreements, which become legally binding once ratified, set out which country gets to tax particular forms of income in a variety of specific situations. Tax treaties also help in the enforcement of the tax law, by providing for exchanges of information between tax authorities. And the treaties include mechanisms for resolving differences of view between countries on questions like the characterization of a particular item of income or where it was earned.

With a dynamic economy and a mobile population, tax treaties are increasingly important for Canada. Those who benefit from this country's tax treaties include established businesses that operate or invest abroad, new ventures that seek foreign investment, and individuals who may want to work temporarily in another country or own property there. A tax treaty gives all of these people dependable answers as to where they have to pay tax.

Canada's tax treaty network is extensive: we have DTAs with over 85 countries, including our NAFTA partners, virtually all of the European Union and OECD (Organization for Economic Co-operation and Development) countries, many members of the Commonwealth and La Francophonie, and rapidly growing countries such as Brazil, Russia, India, China and South Africa.

Canada-United States Income Tax Convention

The Canada-United States tax treaty is, given the depth of Canada's ties with the United States, particularly important. Like all of Canada's DTAs, the Canada-U.S. treaty is based on a model developed by the OECD, but it has always included some special features that reflect the unique Canada-U.S. relationship. As cross-border business and investment practices evolve, the tax treaty has to change as well if it is to remain effective.

The current Canada-U.S. Income Tax Convention was first signed in 1980. It has been updated four times – in 1983, 1984, 1995 and 1997. These four "Protocols" (sets of changes to the treaty) covered a wide spectrum of points, but they all helped to ensure the treaty adopted the latest developments in the two countries' tax policies as well as the changing needs of Canadian and U.S. individuals and businesses.

Canada's 2007 Budget noted that agreement in principle had been reached with the U.S. on a fifth Protocol to update the tax treaty.

The Fifth Protocol

The Protocol signed on September 21, 2007 proposes to change and update many of the provisions of the existing Canada-U.S. Income Tax Convention. This fifth

Protocol will enter into force once it is made law ("ratified") by both the Canadian and United States governments (or on January 1, 2008, if it is ratified in 2007). The Protocol is accompanied by two exchanges of diplomatic notes which set out many of the more technical aspects.

Below are brief explanations of several key elements of the Protocol:

Elimination of "withholding tax" on interest

Who it affects: Any resident of Canada or the United States who pays interest to a person in the other country.

Current rule: If interest is paid across the Canada-U.S. border, the tax treaty generally allows the payer's home country (the "source country") to tax that interest. The tax, at up to a 10% tax rate, is collected by requiring the payer to withhold and remit a portion of the interest payment – hence the term "withholding tax".

New rule: The source country cannot tax cross-border interest.

Example: A resident of Canada who borrows money from a U.S. lender will no longer have to withhold and remit Canadian tax on the interest payments.

Significance: Reduces borrowing costs; makes cross-border investment more efficient.

Application: Applies to interest paid between unrelated (arm's length) persons – e.g. a bank and its customer – as of the second month after the Protocol enters into force. For interest paid between related persons – e.g. a subsidiary company and its parent company – full exemption applies as of the third year after entry into force. (For the first and second years after entry into force, the source country tax rate limit is reduced from 10% to 7% and 4%, respectively.)

Mandatory arbitration

Who it affects: Residents of Canada or the United States who face potential double taxation that is not resolved through the treaty's rules or by negotiation between the two revenue authorities.

Current rule: In addition to its many specific provisions, the tax treaty has a general backstop rule that allows the revenue authorities to agree in cases where the treaty does not resolve an issue between them. (A voluntary arbitration procedure – one in which the two countries must themselves agree with the taxpayer to send the matter to an arbitration board – is authorized under the current treaty, but has not been implemented.) If the revenue authorities do not resolve the dispute between them, there is no further mechanism to resolve the dispute. This means that taxpayers cannot be assured that their double taxation problems will be resolved.

New rule: In the most important kinds of issue that require agreement by the revenue authorities, taxpayers can compel the authorities to refer their dispute to

binding arbitration. Note that this procedure is entirely elective for the taxpayer: the new rule is described as "mandatory arbitration" because it is mandatory for the revenue authorities

Example: A U.S. company sells goods to its Canadian parent company for a certain price. The U.S. company is subjected to a U.S. transfer pricing audit that determines a higher price should apply to the goods, and assesses more income in the hands of the subsidiary. However, Canadian authorities do not agree with the higher transfer price and decline to increase the Canadian company's cost of the goods. The two tax authorities cannot reach agreement. The companies can, subject to certain conditions, choose to require the tax authorities to put the matter to binding arbitration. Details of the arbitration process are set out in an exchange of diplomatic notes.

Significance: Increases taxpayers' confidence that the tax treaty will resolve potential double taxation.

Application: Applies to cases that are, when the Protocol enters into force, already under consideration under the treaty's mutual agreement procedure, as well as cases that subsequently come under consideration.

Taxpayer migration – protection against double taxation

Who it affects: Individuals who cease to be resident in one country and become resident in the other.

Current rule: The tax treaty allows each country to tax its residents on all of their capital gains. No provision is made for the possibility that a country may tax emigrants on any pre-departure gain (as Canada does, by treating them as having disposed of most kinds of property for fair market value proceeds).

New rule: If, on ceasing to be resident of one country and becoming resident of the other, an individual is treated by the first country as having disposed of a property, the individual can choose to be treated also in the second country (the new home country) as having disposed of and reacquired the property at the time of changing residence.

Example: An emigrant from Canada to the U.S. owns shares that cost $100 and are worth $1,000. Canada treats the emigrant as having sold the shares for $1,000, realizing a $900 capital gain ($450 taxable capital gain). The emigrant can choose to be treated for U.S. tax purposes as having realized that $900 gain before becoming resident in the U.S. The U.S. may tax any future gain over the $1,000 value of the shares, but will not tax any of the gain that accrued while the individual was resident in Canada.

Significance: Prevents double taxation of pre-migration gains.

Application: Applies to dispositions (i.e. emigrations) that took place after September 17, 2000 (the date on which the U.S. Treasury and Canada's Department of Finance announced agreement on this issue).

"Limited liability companies" (LLCs) and other hybrid entities

Who it affects: Entities that are treated as corporations under the law of one country, but are treated as partnerships (or "pass-through vehicles") in the other country.

Current rule: No specific accommodation of these hybrid entities. To benefit from the tax treaty (reduced withholding taxes, etc.), an entity must be resident in (i.e. taxable in) one of the treaty countries. If an entity is a pass-through vehicle in its home country, it is not taxable there; instead, its investors are taxed directly as it earns income. But if the other country sees the entity as a corporation, that other country will apply the residence test (taxability) to the entity itself, and the entity will fail.

New rule: Income that the residents of one country earn through a hybrid entity will in certain cases be treated by the other country (the source country) as having been earned by a resident of the residence country. On the other hand, a corollary rule provides that if a hybrid entity's income is not taxed directly in the hands of its investors, it will be treated as not having been earned by a resident.

Example: U.S. investors use an LLC to invest in Canada. The LLC – which Canada views as a corporation but is a flow-through vehicle in the U.S. – earns Canadian-source investment income. Provided the U.S. investors are taxed in the U.S. on the income in the same way as they would be if they had earned it directly, Canada will treat the income as having been paid to a U.S. resident. The reduced withholding tax rates provided in the tax treaty will apply.

Significance: Removes a potential impediment to cross-border investment. Reduces incidence of "double non-taxation" through better matching of tax rules in the two countries.

Application: Basic rule applies for withholding tax purposes as of the second month after the Protocol enters into force. Corollary rule applies after two years.

Pensions & other registered plans – mutual recognition

Who it affects: Cross-border commuters – individuals residing in one country and working in the other – who contribute to a pension plan (or any of certain other employment-related retirement arrangements) in the country where they work. Also individuals who move from one country to the other on short-term (up to five years) work assignments, and continue to contribute to a plan or arrangement in the first country. In certain cases, such persons' employers may also benefit.

Current rule: No rule in respect of contributions, meaning no assurance that they may be deducted for tax purposes in the country of employment.

New rule: Provided certain conditions are met, cross-border commuters may deduct, for residence country tax purposes, the contributions they make to a plan or arrangement in the country where they work. Similarly, those who move for work and meet certain conditions can deduct, for source country tax purposes,

their contributions to a plan or arrangement in the other country, for up to five years. In both cases, accruing benefits are not taxable.

Examples: (1) A resident of Canada is employed in the U.S., and contributes to an employer-sponsored pension plan there. The employee's contributions to the plan (up to the employee's remaining RRSP deduction room) will be deductible for Canadian tax purposes. (2) An employee of a Canadian company is assigned for three years to a related U.S. company. The employee keeps contributing to the employee pension plan of the Canadian company. For U.S. tax purposes, both the employee and the U.S. company will be able to deduct the contributions.

Significance: Facilitates movement of personnel between the two countries by removing a possible disincentive for commuters and temporary work assignments.

Application: Applies for taxation years that begin after calendar year in which the Protocol enters into force. However, if ratification is completed in 2007 the rule applies for taxation years that begin in 2008 (i.e. the same calendar year that the Protocol enters into force).

Stock options – apportionment of taxing rights

Who it affects: Employees who are granted employee stock options while employed in one country, and who then work for the same or a related employer in the other country before exercising or disposing of the option (or disposing of the share).

Current rule: No specific rule provides for the apportionment between the two countries of a stock option benefit in such cases.

New rule: The income in question (the stock option benefit) will generally be considered to have been derived in a country to the extent that the individual's principal place of employment was in that country during the time between the granting of the option and its exercise (or the disposition of the share).

Example: An employee of a United States company is granted a stock option on January 1, 2009. On January 1, 2010, the employee is moved from the company's U.S. head office to its Canadian subsidiary. On December 31, 2011, the employee disposes of the option, giving rise to an income inclusion. Unless the revenue authorities agree that the circumstances warrant departing from the usual rule, one third of the income will be treated as having arisen in the U.S., and two thirds in Canada.

Significance: Gives clarity as to the "sourcing" of stock option benefits; adds certainty that double taxation will not arise.

Application: As a set of detailed, technical rules, this is included in an exchange of diplomatic notes, rather than in the Protocol itself. Enters into force on the same date as does the Protocol.

Next Steps

To take effect, the Protocol must be ratified according to the applicable procedures in both Canada and the United States. For Canada, this means making the Protocol a part of Canadian law, by enacting a statute to that effect. The Protocol will thus be presented to Parliament in a Bill, which – as with any other Bill – both the House of Commons and the Senate must approve and which must obtain Royal Assent.

The Government of Canada intends to proceed with the required Bill at an early opportunity.

For Additional Information

The existing Canada-United States Income Tax Convention is available on the Department of Finance website, at http://www.fin.gc.ca/treaties/USA_e.html.

Many public libraries in Canada hold, often in their reference collection, one or more commercial editions of the *Income Tax Act* that also include the Convention and related materials.

Information on pending legislation, including tax treaty Bills, is available through the Parliament of Canada website, at
http://www.parl.gc.ca/LEGISINFO/index.asp?Language=e